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Postponing Greece's inevitable default

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Even though the Greek parliament has given the government some breathing space with its vote of confidence late on Tuesday, a default by Greece is inevitable. With a debt to gross domestic product ratio of more than 150 per cent, large annual deficits and interest rates more than 25 per cent, the only question is when the default will occur. The current negotiations are really about postponing the inevitable default.

If Greece were the only insolvent European country, it would be best if its default occurred now. Cutting its debt in half and replacing the existing debt with low interest rate bonds would allow Greece to service its debt without the excruciating pain that would be involved if it tried to service its current debt.

But Greece is not alone in its insolvency and a default by Athens could trigger defaults by Portugal, Ireland and possibly Spain. The resulting losses would destroy large amounts of the capital of banks and other creditors in Germany, France and other countries. There would be a drying up of credit available to businesses throughout Europe and there could be a collapse of major European banks.

This inevitable contagion and its potential consequences for the European financial system is the reason the European Central Bank is determined to avoid a default at this time. The challenge, therefore, is to find a way to postpone the defaults long enough for the banks and other creditors to withstand the write-downs of bond values if Greece, Portugal and Ireland default simultaneously.

The process is complicated by the German government's position that it will support the extension of more official credit now only if the existing private creditors participate. The ECB insists that the private creditor participation must be "voluntary" so that no technical default occurs.

The essential feature of any solution is therefore for the existing bondholders to "voluntarily" agree to capitalise the interest that is now due and to provide new multi-year loans at a below-market interest rate to replace the bonds that are now maturing. That should satisfy the German demand for participation of private lenders while meeting the ECB's requirement that any adjustment be voluntary so that no default is deemed to occur.

But how to get the existing creditors to agree to these terms? If it is not to be mandatory, it must be in each creditor's interest to do this. Three things might make this possible.

First, if a bank does not capitalise interest and provide a new loan, the old loan will default, reducing the bank's accounting capital and its ability to lend. Banks and other creditors will want to avoid that. Second, the ECB has indicated that restructured debt that is the result of a default will not be eligible as collateral at the central bank while new loans that are voluntarily made will be. And, third, there will be peer pressure among banks and other creditors to recognise that they all benefit by avoiding a default.

Avoiding a loss of accounting capital, having an asset that can be used as collateral with the central bank and acceding to peer pressure may be enough to cause banks and other creditors to create new loans at favourable rates. If not, further inducements from the ECB and the European Union will be needed.

With time, the creditor banks and other financial institutions that hold the debt of Greece, Ireland and Portugal will be able to sell or otherwise transfer that debt to the ECB or other potential buyers and to accumulate earnings to build up their capital ratios.

When the ECB eventually determines that major creditors have reduced their holdings of the impaired debt by enough so that, in combination with their increased capital, they are able to withstand substantial debt writedowns, the ECB will allow Greece, Ireland and Portugal to have a simultaneous default in which they restructure their existing debt to levels that they can comfortably service.

This type of plan worked well for the Latin American debt in the 1980s, culminating with the substitution of Brady bonds for existing debts.

There is of, course, no guarantee that this will work for the eurozone's peripheral debtors. A major uncertainty is whether Spain will also need to restructure its debt. Although the debt of Spain's central government looks manageable, the impaired assets of the Spanish saving banks and the debts of the individual regions may make the eventual total obligations of the central government impossible for Madrid to service. And Spain's potential debts are larger than the other three nations' impaired sovereign debts combined.

There are two further problems that will make it difficult for this strategy to work in Europe. First, the contractionary fiscal policies that are decreasing aggregate demand and GDP in these countries cannot be offset by the expansionary effects of currency devaluations as they were in Latin America. Moreover, even when the debt overhang is eliminated, the peripheral countries will not be competitive in world markets at their existing exchange rates. As members of the eurozone, they cannot devalue.

So settling the debt problem would still leave these countries with the large current account deficits that now exist and that will continue to exist in the future.

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